Supreme Court of the United States

No. .....

TERM A. D. 1944.

F. G. BADENHAUSEN, WILLIAM S. SPATCHER and HOWARD H. HUBBARD, constituting the Protective Committee for the Holders of Georgia and Alabama Railway First Mortgage Consolidated Five Per Cent. Gold Bonds, Due 1945,

Petitioners and Appellants Below,

AGAINST

GUARANTY TRUST COMPANY OF NEW YORK and MERREL P. CALLAWAY, as Trustees of Seaboard Air Line Railway Company First and Consolidated Mortgage, dated September 1, 1915; *et al.*,

Respondents and Appellees Below.

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IN THE CAUSE

OF

Guaranty Trust Company of New York and Merrel P. Callaway, as Trustees, et al., Complainants v. *Seaboard Air Line Railway Company, et al., Defendants.* Consolidated Cause. In Equity No. 214. And in the constituent causes numbered 213, 214, 228, 229, 172, 173, 174, 237 and 238 of said consolidated cause.

Brief in Support of Petition for Writ of Certiorari.

ABRAHAM MITNOVETZ,
Attorney for Petitioners.

HARRY O. LEVIN,
Of Counsel.

Brief in Support of Petition for Writ of Certiorari.

Opinions Below.

The opinion of the United States Circuit Court of Appeals for the Fourth Circuit is not yet officially reported. The opinion is printed in full in the printed Appendix to the Record on Appeal (Vol. III, 9-39).

The opinion of the United States District Court for the Eastern District of Virginia is reported in 53 F. Sup. 672. The opinion is also printed in full in the printed Appendix to the Record on Appeal (pp. 81-145).

The Special Master's Report is designated as Vol. II in the Record on Appeal.

Jurisdiction.

The jurisdiction of this Court to review the judgment here in question is invoked under the Act of February 13, 1925 (C. 229; 43 Stat. 938), amending the Judicial Code Section 240, Title 28, U. S. C. A., Section 347, and under Rule 38, subdivision 5, of the Rules of the Supreme Court. A statement of the grounds on which the jurisdiction of this Court is invoked is contained in a petition pursuant to Rule 38 (5) (b), filed herewith, *supra*, pages 15-21, and petitioners respectfully request that said statement be deemed incorporated in the Brief at this point. Judgment was entered in this case on August 2, 1944 (Vol. III, 39-40). The time to file the petition herein has been extended to December 2, 1944 by order of this Court.

Statement of the Case.

The essential facts of the case are presented in the petition filed herewith (*supra*, pp. 2-12) to which petitioners respectfully refer. In the interest of brevity, the facts are not repeated here. It will be noted, however, that there are no controverted issues of fact in this case.

Specification of Errors.

1. The District Court erred in proceeding to reorganize the Seaboard Railroad System in equity, after the passage of Section 77 of the Bankruptcy Act. The Circuit Court erred in sanctioning this procedure.

2. The Circuit Court of Appeals and the District Court erred and violated the due process of law guaranteed by the Federal Constitution in adopting the allocations and modifications in the Plan of Reorganization recommended by a Compromise Committee consisting only of representatives of certain partisan interests which purported to act in a judicial capacity over issues affecting the petitioners as well as the other bondholders of the System.

3. The Circuit Court of Appeals, in sanctioning the procedure of the District Court with respect to the Compromise Committee, so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by a lower court, as to call for an exercise of this Court's power of supervision.

4. The Circuit Court of Appeals, in approving the allocations of securities recommended by the Compromise Committee to the various bondholders and adopted by the District Court without any basis for the support thereof in law or fact, erred and violated the due process of law guaranteed by the Federal Constitution.

5. The Circuit Court of Appeals and District Court erred in using the same level of earnings as a base for the distribution of junior securities as well as for the distribution of senior securities.

6. The Circuit Court of Appeals erred in approving the Secondary Allocation adopted by the District Court,

which distributed large portions of the wartime earnings and securities released by wartime earnings on a pre-war basis predicated solely on what each of the mortgage divisions earned in the period 1936 to 1940 without considering what each mortgage division earned during the years these funds were accumulated.

7. The Courts below erred in failing to apply the "Segregation Formula" adopted by them to the recent earnings in the years 1941 to 1943.

8. The Courts below erred in adopting the "Kennedy Segregation Formula" to ascertain the earnings of the various mortgage divisions of the System which was based upon false and artificial assumptions and which primarily determined the allocation of the new securities to the various divisions.

9. The Courts below erred in giving predominant weight to the socalled "segregated earnings" of the different mortgage divisions as ascertained under the adopted Kennedy Formula which was predicated on false and artificial assumptions.

10. The Plan of Reorganization approved by the District Court and Circuit Court of Appeals is erroneous in that it fails to fairly and equitably compensate the Georgia and Alabama Bondholders for the full amount of their claims and the loss of their first mortgage position.

POINT I.

The District Court erred in proceeding to reorganize the Seaboard Railroad System in Equity after the passage of Section 77 of the Bankruptcy Act.

The decision of the Circuit Court of Appeals approving and affirming the procedure of the District Court in reorganizing the Seaboard Railroad System in equity, after

the passage of Section 77 of the Bankruptcy Act, is in direct conflict with the decision of the Circuit Court of Appeals, Second Circuit, on the same matter, in the case of *New England Coal & Coke Co.* v. *Rutland Railroad Co.*, 143 F. (2d) 179.

The Circuit Court of Appeals, Second Circuit, has in effect said that the continuance of equity receivership proceedings after the enactment of Section 77 of the Bankruptcy Act is now "a means for the frustration of the public policy of the United States as embodied in Section 77." In the instant case the District Court and Circuit Court of Appeals proceeded to approve a Plan of Reorganization in equity long after the passage of Section 77 of the Bankruptcy Act (Vol. III, pp. 23-25, Cir. Ct. Op.).

The conflict between the two Circuit Courts of Appeal involves an important question of federal law which has not been but should be settled by this Court (Supreme Court Rule 38, par. 5[b]). The question involved has a public aspect and is of primary importance to all railroads now in the process of reorganization and it is essential in the public interest that the question be reviewed and finally settled.

The major problems which have arisen before the District Court are a result of the extraordinary procedure which has heretofore taken place. As appears throughout his Report, the Master herein has endeavored to act as if he were the Interstate Commerce Commission, to act as if this were a proceeding before that body, and to substitute his judgment in place and stead of that of the Commission (Vol. I, Ct. Tr., pp. 246-247).

Counsel, herein, argued before the District Court at its first hearing that the two questions generally presented in a railroad reorganization, to wit: (1) What kind of capital structure should be devised and (2) In what manner shall the new securities be allocated among the holders of the various divisional liens, are questions peculiarly

requiring the informed, expert and impartial judgment of the Interstate Commerce Commission. It is an impartial and expert administrative body with an experienced staff devoted to these types of problems, necessary particularly when an allocation of securities is required among holders of different divisional liens whose claims are of equal rank (see Ct. Tr., pp. 1004-1006 in Rec. on Appeal). The District Court likewise remarked that the burden should be on the Interstate Commerce Commission (see Ct. Tr., p. 1659 in Rec. on Appeal).

In the instant case, the learned Master was an experienced railroad attorney who was familiar with the Seaboard Railroad System. As a matter of fact, the Master originally instituted the Seaboard Receivership as solicitor for the Bethlehem Steel Company, when he filed its bill of complaint as a general creditor. The Special Master admitted, however, that he was no railroad expert (Vol. I, Ct. Tr., 246, 247). With all due respect to the learned Master, there is hardly any basis of comparison as to his qualifications, experience and competence with that of the Interstate Commerce Commission.

In *Ecker* v. *Western Pacific R. Co.*, 318 U. S. 448, 468, 469, this Court, referring to Section 77 said:

> "Since railroads could not take advantage of the Bankruptcy Act, Section 4, 11 U. S. C. A., Section 22, their final adjustments for years have been carried out in equity receiverships under judicial control. * * * These reorganizations require something more than contest between adversary interests to produce plans which are fair and in the public interest. When the public interest, as distinguished from private, bulks large in the problem, the solution is largely a function of the legislative and administrative agencies of

government with their facilities and experience in investigating all aspects of the problem and appraising the general interest. Congress outlined the course reorganization is to follow. It established standards for administration and placed in the hands of the Commission the primary responsibility for the development of a suitable plan."

The District Court in its opinion stated:

"Before the passage of the Act of Congress (in 1933) providing for railroad reorganization as a part of the Bankruptcy Law (Section 77) the only juridical mode of railroad reorganization was in equity. Since then it may be thought that equity for such a purpose is outmoded but not outlawed (Vol. I, Dist. Ct. Op., pp. 138-139). * * * It is true that equity procedure in corporate reorganizations had heretofore in many cases proved unsatisfactory and this was the primary reason which prompted the enactment of Section 77 and 77B of the Bankruptcy Act" (Vol. I, Dist. Ct. Op. p. 142).

This same problem however was discussed in the case of *New England Coal & Coke Co.* v. *Rutland Railroad Company, supra,* by the Circuit Court of Appeals for the Second Circuit. After fully and carefully analyzing the various cases applicable thereto, Judge Frank said:

"From those cases we deduce the following: Before the enactment of 77 in 1933 a consent receivership of a railroad was condoned because the Bankruptcy Act was not applicable to such a corporation and such a receivership was therefore often necessary in the public interest to make possible the continued operation of the railroad and

> its preservation as a unit. Since the enactment of Section 77 however, that reason for condoning such a receivership has vanished and it is now *'a means for the frustration of the public policy'*, of the United States embodied in Section 77." (Emphasis supplied.)

And quoted Rep. Rayburn, Chairman of the House Committee in charge of the bill which became Section 77, who said:

> "I believe therefore that in order to protect stockholders, in order to protect bondholders, in order to protect everyone who is a creditor of a railroad, and the public as well, we should pass this or some other legislation at the earliest hour to put an end to these long drawn out, these expensive and in many instances these disgraceful receiverships that have happened in the past."

Although the *"Rutland Railroad"* case, cited *supra*, went into receivership in 1938 *after* the enactment of Section 77 of the Bankruptcy Act and the Court there also held that the original petition was defective, the principles enunciated by the Circuit Court of Appeals, Second Circuit, are equally applicable to the instant case and is authority to the effect, that if a plan of reorganization is to be developed for a railroad, it must, since the enactment of Section 77 of the Bankruptcy Act be consummated under Section 77.

Although in the instant case, the Seaboard System went into receivership in 1931, no attempt was made to reorganize until 1935 when the Court instructed the Receivers to prepare a Plan of Reorganization but it was abandoned after the principal secured creditors opposed procedure along this line, in view of the then relatively poor earnings of the railroad. Several years later on

October 27, 1939, the Court again entered an Order appointing the Master to consider, prepare and submit a Plan of Reorganization, after hearing all parties in interest, but it was not until July, 1943, that the Master finally submitted his Report and proposed Plan of Reorganization.

The District Court, after the Compromise Committee proposed its modifications as hereinafter set forth (see Point II), confirmed the Master's Plan as modified by the Compromise Committee, under the mistaken belief of the Court that it was the duty of the Court to aid in effectuating the Plan of Reorganization in Equity since a very large majority of the debenture holders had assented to it. This inference clearly appears from the Opinion of the District Court (Vol. I, 134, 137, 141-142).

It is clear that the rights and claims of a minority group of creditors, if their claims are just and equitable, should not be prejudiced or waived through the coercion of a majority of the other secured creditors whose interests would benefit thereby.

> *First National Bank* v. *Flershem*, 290 U. S. 504, 515-516, 525-562;
>
> *New England Coal & Coke Co.* v. *Rutland Railroad Company, supra.*

Nevertheless, the approval of the instant Plan in Equity seems to have been predicated by the District Court substantially upon the fact that most of the debenture holders in the instant case had assented to the Plan (Vol. I, Dist. Ct. Op., pp. 115, 126-128, 134, 137, 141-142). This is likewise true of the Circuit Court of Appeals (Vol. III, pp. 30, 31).

POINT II.

The Circuit Court of Appeals erred and violated the due process of law guaranteed by the Federal Constitution in sanctioning the appointment by the District Court of a Compromise Committee consisting only of representatives of certain partisan interests, which purported to act in a judicial capacity over issues affecting the petitioners, as well as the other bondholders of the system.

The Circuit Court of Appeals, in sanctioning the procedure of the District Court with respect to the Compromise Committee, so far sanctioned a departure by a lower court from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

The allocation of securities recommended by the Compromise Committee and approved by the lower Courts, were arbitrary and illegal, without any basis for their support in law or in fact.

At the close of the first hearing the District Court rendered its tentative views on certain of the issues. In discussing the unfairness of the results of the Master's Plan with respect to the G. & A. Ry., the Court stated:

> "Furthermore, I think that a great deal of influence ought to be given to the recent earnings which are now causing emphasis on the contest that we have. Just how those recent earnings ought to be influential in what is the final allocation of securities is largely a business question. I think we were told during the hearings that the Georgia & Alabama had made net earnings of something over a million dollars in the last year or two and that they are awarded securities on the basis here in the plan which would not amount to much more

than that; furthermore, that the scrap value of the Georgia & Alabama is pretty nearly as much as the market value of the securities that are awarded to it. Those things cry out for adjustment and just how they can be adjusted is much more a matter of good business judgment than it is merely of legal principles" (Vol. I, Ct. Tr., p. 360).

The District Court then discussed the practical or business aspect of deciding the issues before the Court on a *compromise basis* rather than on a legal or judicial basis in order to expedite the reorganization, at this particular time, when the earnings of the System were at their highest level (Vol. I, Ct. Tr., pp. 365-368). (See Rec. on Appeal Ct. Tr., pp. 1314-1386). The Court suggested that a Compromise Committee be appointed to negotiate with the interested parties, whose rights appeared to be adversely affected by the Master's Plan, so that a Plan of Reorganization be confirmed which would be agreeable *by consent* to all interested participating parties (Vol. I, Ct. Tr., pp. 365-368). (See Ct. Tr., pp. 1369-1381 in Record on Appeal.)

The Court appointed Messrs. Edwin S. S. Sunderland, Delano Andrews and Joseph France. Mr. Andrews represented the Bondholders Protective Committee and Mr. Sunderland represented the Trustees, respectively, of the System First and Consolidated 6% Mortgage. These gentlemen were nominated as the spokesmen for all of the general mortgages. The third member of the Committee appointed was Mr. France, Counsel for the Underlying Bondholders Committee, which had on deposit, bonds of *all* the underlying mortgage divisions although their interests unquestionably conflicted.

This Compromise Committee is understood to have conferred with all of the interested parties, but seemed subsequently to be laboring under the conception that

they were acting in a *judicial* capacity rather than as a compromising or negotiating body. This attitude appears throughout the entire Report of the Committee (Vol. I, Compromise Com., Exh. I, pp. 415, 417-418).

The absurdity of these assertions that the Compromise Committee were acting as judicial officers of the Court and were exercising an *impartially informed judgment* as to the various adjustments made, is apparent from the actual facts as evidenced by the entire record. The District Court stated on several occasions at the first hearing that the Master's Plan was, if anything, much too favorable in so far as the general mortgages were concerned and unsatisfactory as to the underlying divisions (Rec. on Appeal, Ct. Tr., pp. 607-608). Mr. Sunderland and Mr. Andrews unquestionably favored the confirmation of the Master's Plan *in toto* at all times, although they urged certain minor exceptions (see Rec. on Appeal, Ct. Tr., p. 1345) (Vol. I, Comp. Com. Exh. I, pp. 417-418). On the other hand, the various representatives of the several underlying liens on the whole strenuously objected to the Master's Plan. The Underlying Bondholders Committee, which purportedly represented *all* ten of the underlying liens, had always favored the socalled "earning" underlying divisions and for all practical purposes had abandoned the true representation of the socalled "deficit" divisions, just as it had abandoned representing a subsidiary, Georgia & Alabama Terminal, whose bonds still were on deposit and represented (Vol. I, Ct. Tr., p. 399). Petitioners made this charge early in the proceedings, when they filed a petition praying the Court to direct the Underlying Committee to cease to represent the bondholders of the G. & A. Ry., in view of the sharp conflict of interest which existed between each of the various lines.* This conflict of interest among the under-

*This petition was subsequently denied by the District Court and an appeal from this decision is now pending before the Circuit Court of Appeals.

lying divisions became more apparent and pronounced between the socalled *"earning"* divisions and *"deficit"* divisions. It is not unfair to say that the only active representatives of any of the socalled "deficit" divisions were the petitioners herein. Although this issue has been unfavorably decided by the District Court, it is respectfully submitted petitioners' contention is fully supported by the Supreme Court in the case of *Woods* v. *City National Bank & Trust Company of Chicago, et al.*, 312 U. S. 262, decided February 3, 1941.

For the members of the Compromise Committee to assert that they were acting impartially and as judicial officers of the Court is ridiculous. Each one was an interested party in the proceedings and strongly partial to his own interests. Furthermore, it is inconceivable in American jurisprudence that anyone should or could act in a judicial capacity in a proceeding where their own interests are involved.

It is likewise apparent from the record that the attitude of the Underlying Committee and its counsel toward the petitioners as representatives of the Georgia and Alabama Division, was a most hostile one. This was further evidenced by the testimony of the Underlying Committee's expert, Mr. Wyer, who was in fact the strongest opposition witness in so far as the Georgia and Alabama Bondholders were concerned. It is clear that the presence of the counsel for the Underlying Bondholders Committee on the Compromise Committee was not conducive to improving the treatment of the Georgia and Alabama Division, which probably accounts for the poor treatment it received.

The Securities and Exchange Commission, in discussing this same problem in its "Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, made pursuant to Sec. 211 of the Securities and Exchange Act of 1934", stated:

"Above all things, see to it that neither your Committee nor any other committee represent conflicting interests. It is a rule to which there are few exceptions that the same protective committee should represent but one class of securities. * * * If the interests of the several classes of Security-holders are not to suffer as a result of concession too readily or unnecessarily made, their representatives at the conference table should have *undivided* loyalty to the class which they represent" (Report, Part II, p. 395). (Italics ours.)

A compromise necessarily is based upon the consent of all interested parties. In the instant case, the G. & A. Ry. Protective Committee, the petitioners herein, at no time accepted or agreed to the modifications proposed by the Compromise Committee. As a matter of fact the proceedings of the Compromise Committee were kept highly secretive. No indication was given by the Compromise Committee of what the recommended modifications as to the various issues would be until the very day of the hearing, when the recommendiations were arbitrarily submitted by the Compromise Committee without any explanation whatsoever as to the manner or *methods* in which they obtained these results or the *reasons* for these results, except that it was stated that they were obtained from an impartial informed judgment (Vol. I, Comp. Com. Ex. I, pp. 415, 417-418, 420). Wyer, the Underlying Bondholders Committee's expert, testified that he could not subscribe to the *methods used* for obtaining the compromise but was in favor of its results (See Rec. on App. Ct. Tr., p. 1416). Kennedy, the First and Consolidated General Mortgage expert, testified likewise.

It may be stated unequivocally that the modifications made by the members of the Compromise Committee were

in effect, a judgment in their own favor. All of the members of the Compromise Committee had prejudicial interests. The securities they actively advocated and represented at the hearings, benefited substantially in the results of the modifications proposed by them. It must be remembered that the real interest of *all* the members of the Compromise Committee lay in the treatment which the so-called "*earning*" divisions received under the Master's Formula. As stated by the District Court the principal objection of the Underlying Committee was in the treatment of deficits, which affected only the socalled "*earning*" divisions. The Master disregarded the "deficits" of the mortgaged and leased lines which had the mathematical effect of charging same to all of the underlying divisions which were "earning" divisions (Vol. I, Dist Ct. Op., pp. 116-117).

The Compromise Committee settled this issue by charging the deficits on the underlying mortgage divisions against the System mortgage having the next junior lien on the property in question or where there was no junior lien, as in the case of leased lines, by distributing the deficits *pro rata*. This resulted in improving the treatment of the underlying "earning" divisions which were actively represented by Mr. France. On the other hand, it was to the interest of the general mortgages to improve the treatment of the socalled underlying "earning" divisions but not the "deficit" divisions. The reason for this is, that the general mortgages in addition to having a first lien on certain of the underlying "earning" divisions also had a second lien on the other underlying "earning" divisions and the *surplus* of "earnings" went to the general mortgages after satisfying in full the claim of the divisional first mortgage. Thus, the general mortgages would gain nothing if they improved the treatment of the "deficit" divisions as the first mortgages on these divisions would still not be paid

in full and that there would be no surplus to go to the general mortgages (Vol. III, p. 16, Cir. Ct. Op.).

This is further illustrated by their approval of the Master's Secondary Allocation as well as by the Tertiary Allocation proposed by the Compromise Committee. In their Report, the Committee stated that it recognized the fundamental of fairness and equity in providing for distribution of normal war earnings to holders of securities *whose properties have produced such earnings* and also referred to similar recognized proposals on other proceedings (Vol. I, Comp. Com. Ex. I, p. 419). They stated they gave effect to this principle by the use of the Tertiary Allocation, which was only *partially true*. This Tertiary Allocation is predicated upon the assumption that the Primary Allocation and Secondary Allocation proposed by the Master is correct and proceeds, in effect, to distribute the additional released securities as if they were declared dividends on the securities originally allocated on the same basis as developed by Wyer's Court Exh. No. 3 (Vol. I, p. 441). A comparison of the results appears on the Comp. Com. Exh. 4 (Vol. I, p. 428).

However, this Tertiary Allocation is only applied to the securities released by the cash provisions made for the acquisition of Tampa Northern, and Georgia, Florida and Alabama bonds. As the District Court in its opinion (Vol. I, p. 125) states, after making certain block allotments therefrom (which have never been specified in the District Court Record), the balance of new securities so released and distributed amounted to $539,980 First Mortgage Bonds, $450,676 in Income Bonds, $105,136 par value Preferred Stock and $992,203 par value Common Stock.

However, as previously stated, during the last two years and with the wartime earnings, the Receivers have purchased and acquired about *$34,000,000* par value of outstanding Receivers' certificates and secured obligations of the System which have released for redistribution corre-

sponding amounts of new securities. It will be seen therefore, that the amount of securities which were purchased from wartime earnings and which are purportedly distributed to the holders of those securities whose properties have produced such earnings (as proposed in the Tertiary Allocation) is minute as compared to the actual securities so purchased. The vast bulk of such securities, including the securities released from the purchases of Receivers' certificates in excess of $34,000,000 are all allocated *only* on the *basis of the segregated earnings*, as established by the "Kennedy Formula", during the period of *pre-war* and low level earnings, to wit, 1936 to 1940, which is known as the Secondary Allocation. Mortgage divisions, such as the G. & A. Ry. which are highly valuable and which have contributed heavily to these cash purchases during the wartime period receive no part of these securities, since they show no segregated earnings in 1936 to 1940. Since the Tertiary Allocation is predicated on the Secondary Allocation, as well as the Primary Allocation, the error is multiplied (Vol. III, pp. 26-27, 34-35, Cir. Ct. Op.).

In conclusion, it is interesting to compare the increase in the allocation of securities recommended by the Compromise Committee with respect to the G. & A. Division and the Atlanta and Birmingham Division, as shown in the Compromise Committee's Exhibit #4 (Vol. I, p. 428).

G. & A. Ry. receives the following increase:

First Mortgage Bonds	*Income Bonds*	*Preferred Stock*	*Common Stock*
$361,018	$14,125	$3,295	$28,904

Total Increase $407,342.

ATLANTA AND BIRMINGHAM.

First Mortgage Bonds	*Income Bonds*	*Preferred Stock*	*Common Stock*
$976,210	$605,869	$106,036	$614,144

Total Increase $2,302,259.

Yet it will be noted after comparing Wyer's Court Exhibit No. 1 (Vol. I, p. 411) and the Compromise Committee's Court Exhibit No. 8 (Vol. I, p. 433), that the earnings of the G. & A. Ry. equalled the earnings of the Atlanta Birmingham Division in 1942 and probably exceeded it in 1943, in view of Wyer's testimony that the Georgia and Alabama Division probably earned 1½ million to 2 million dollars in 1943 (Vol. I, Ct. Tr. 370-371).

The approved Plan of Reorganization and the allocations made therein is unfair on its face.

POINT III.

The Secondary Allocation adopted by the District Court and approved by the Circuit Court of Appeals, which redistributed most of the cash and securities released by the huge wartime earnings on a pre-war basis predicated solely on what each of the mortgage divisions earned in the period 1936 to 1940 is unfair and inequitable and involves an important question of federal law which has not been but should be settled by this court.

The decision of the Circuit Court of Appeals (Vol. III, p. 34) approved the Secondary Allocation adopted by the District Court which redistributed most of the securities released by the *wartime* earnings on a *pre-war basis* predicated solely on what each of the mortgage divisions earned

in the period 1936 to 1940. Its failure to consider the recent earnings of the mortgage divisions whose properties produced such earnings in the years 1941 to 1943, is not only inequitable but involves an important question of federal law which has not been but should be settled by this Court.

The question as to whether the wartime earnings (or securities released by purchases from wartime earnings) in a railroad reorganization should be distributed on an actual earnings basis during those years *when* they were *acquired* or whether the funds and the securities so acquired should be distributed, among the various mortgage divisions, on a *pre-war* basis and in different pre-war ratios, contrary to the actual facts, has never been adjudicated by this Court so far as our research indicates. It involves an important question of federal law of great importance to the public and other railroads presently in receivership or bankruptcy.

It must be emphasized that in the point now being considered, the petitioners *do not* contend that wartime earnings can serve as a reliable criterion for the indefinite future. The problem here is entirely different. The problem involves the redistribution of securities released or cash obtained from wartime earnings which have been *actually earned*, among various first mortgage divisions of equal rank. It must be recognized that there is a great distinction between using wartime earnings as a base for establishing future earnings and the consideration of wartime earnings as actually earned; one is based *in futuro*, the other is an *accomplished fact*.

In the instant case huge amounts of cash have been rapidly accumulated by the Seaboard System from the current earnings, particularly during the years 1942 and 1943, (and probably 1944). This surplus cash has been applied to the payment of senior claims and other secured obligations of the System. The purchase of these securities have materially reduced the claims which

were originally admitted to participation in the new corporation and have released equivalent amounts of the new securities of the permitted capitalization for redistribution among the various mortgage divisions.

In the instant case the securities which must be redistributed are in excess of $34,000,000; nearly all of the securities were purchased and acquired by the Receivers under orders of the Court to the effect that the application of the moneys therefor should be without prejudice to claims of parties of interest with respect to the application of moneys so used (Vol. I, Dist. Ct. Op., p. 90).

Under the Secondary Allocation adopted by the Courts below, most of these securities have been distributed to the various mortgage divisions on an earnings basis made in a synthetic average year for the period 1936 to 1940. Many of the mortgage divisions including the Georgia & Alabama Railway showed no net earnings during this period and were designated as "deficit lines" under the Segregation Formula adopted, whereas in the years the wartime earnings were accumulated, all of these socalled "deficit lines" admittedly became huge earning divisions which produced much of the cash or equivalent securities now being distributed in which they do not participate.

The Compromise Committee in its report stated:

> "It may well be noted that as to the fundamental principle of fairness and equity in approving for distribution the abnormal war earnings to holders of securities whose properties have produced such earnings, generally similar proposals, different in method and form, have been made and have been or are being dealt with in railroad reorganization proceedings pending before the Interstate Commerce Commission and the federal courts" (Vol. I, p. 419).

The Compromise Committee stated that they gave effect to this principle by the use of the Tertiary Allocation. Unfortunately the Compromise Committee *failed to practice what it preached.* The Tertiary Allocation only applied to a small proportion of the securities and cash released by the wartime earnings. In so far as the balance and bulk of the $34,000,000 securities obtained from wartime earnings were concerned, to which the Tertiary Allocation was *not applied,* the District Court and Circuit Court of Appeals adopted the Secondary Allocation proposed by the Master, which re-allocated the released securities solely on the basis of the earnings in the socalled average year in the period 1936 to 1940. It must further be noted that the Tertiary Allocation distributes the released securities as if they were declared dividends on the securities previously allocated to the various mortgage divisions. It follows that the Tertiary Allocation is predicated on the assumption that the previous allocations are correct and in effect multiplies the errors indicated in the Primary and Secondary Allocations.

It will be seen that the present Plan of Reorganization in reality consists of three distinct allocations—the Primary, Secondary and Tertiary Allocations.

In the Primary Allocation, the first mortgage bonds allotted to the underlying mortgaged properties were allocated among the so-called earning divisions on the basis of their average segregated earnings for the period 1936 to 1940, with certain adjustments. The income mortgage Bonds were allocated to the various divisions, one-half on the basis of segregated earnings, and the other half on the basis of the net value of freight contributions, with the exception, that the 7½ million of such Income Bonds originally allotted to Receivers' certificates, purchased by the Receivers were reallocated wholly on the basis of segregated earnings. The preferred and common stock were allocated one-third on the basis of segregated earn-

ings, one-third on the basis of the net contributions to freight traffic and one-third on the basis of reconstruction cost new less depreciation (Vol. I, Dist. Ct. Op., p. 107).

In the Secondary Allocation proposed by the Master and adopted by the Court, except for the minor Tertiary Allocation, the first mortgage bonds and junior securities which had been primarily allocated to Receivers' certificates and to certain bond issues acquired by the Receivers were reallocated *only* on the basis of *segregated earnings* indicated in the period 1936 to 1940. This Secondary Allocation, based upon segregated earnings only, was also made applicable to all other securities which would be released through the purchase of senior securities by the Receivers in the future (Vol. I, Dist. Ct. Op., p. 125).

The Tertiary Allocation consisted of a minor allocation of new securities which were released by the cash provisions made for the acquisition of Tampa, Northern and Georgia, and Florida and Alabama bonds pursuant to a modification recommended by the Compromise Committee (Vol. I, Dist. Ct. Op., p. 125).

The Secondary Allocation in substance provides that *most* of the securities acquired or cash earned in the boom years of 1942, 1943 as well as 1944, if available for distribution, be distributed irrespective of the actual source, on the basis of segregated net earnings which each division made in a synthetic average year in the period 1936 to 1940 (with the exception of the small quantity of securities to which the Tertiary Allocation was applied).

It now appears that the war traffic is carried in substantially different proportions as between the various mortgaged properties than was the pre-war traffic. The earnings which will have produced the accumulated cash and resulting release of the new securities are the fruits of the various mortgaged properties in ratios quite dif-

ferent from those assumed by the Secondary Allocation adopted in the approved Plan of Reorganization.

All of the increase in earnings is due to additional traffic contributed by the various divisional mortgaged properties. In principle, to equitably redistribute these funds or securities, the re-allocation of such new securities *should be made* by a court of equity upon an earnings basis, to the owners of those properties whose earnings contributed the cash applied by the Receivers for the purchase of these securities. Any funds which were thus applied to the purchase of outstanding securities by the Receivers were unquestionably earned in 1942 and 1943. Therefore this provision in the approved Plan of Reorganization is *very unfair* to those underlying mortgage divisions now showing earnings or greatly increased earnings in years such as 1942, 1943 and 1944, when the volume of traffic and the System earnings are at much higher income levels than the years 1936 to 1940 to which the Segregation Formula was only applied (Vol. I, Ct. Tr., p. 201).

The "Master's Formula" had not been applied to the years 1941, 42 and 43, so that he had no segregation of earnings for these years (Vol. I, Ct. Tr., 222-224) which would have indicated the many changes in earning position which factually have taken place between the mortgaged properties to increase the total System operating revenue from an average of $42,800,000 for the period 1936 to 1940 to $110,400,000 in 1942 and $137,000,000 (as estimated for 1943 (Vol. I, Dist. Ct. Op. p. 96). The mortgage divisions with no earnings or with marginal earnings in such low years not only greatly increased their earnings in these boom years, but also reduced the ratio of their operating expense much faster than the divisions with high net earnings in the years of low gross revenue. As previously stated, this is a phenomena which applies to all operating railroads where the volume of business in-

creases substantially and is clearly proven by Wyer's Court Exh's. 1 and 2 (Vol. I, 409-410).

Wyer's Court Exh. 1 (Vol. I, 409) and his testimony which was not refuted proved that the G. & A. Ry. earned in 1942 under the Kennedy Formula $1,016,937 and on the same basis in 1943 approximately 1½ to 2 million dollars. Yet under the Master's Secondary allocation, G. & A. Ry. received nothing since it showed no segregated earnings in the periods selected, 1936 to 1940.

It is estimated that if the Tertiary Allocation had been applied to *all* the securities released by wartime earnings in the years 1942 and 1943, the Georgia and Alabama Divison would have received additional securities in the amount of $1,315,800.

Is not each mortgage equitably entitled to the income produced by its property during the receivership proceeding? Is it not unfair and inequitable to disregard the source of this cash and distribute the cash or equivalent securities on the basis of the different pre-war ratios? (See Swaine Railroad Reorganization under Sec. 77 of the Bank. Act, Harvard Law Review, Vol. LVI, pp. 1221-1224, July, 1943).

POINT IV.

The decision of the Circuit Court of Appeals holding that it was correct for the District Court to use the same level of earnings as a base for the distribution of junior securities as well as senior securities is erroneous and in conflict with applicable decisions of this court.

In attempting to determine the net earnings of each mortgage division the period selected for the ascertainment of earnings is equally as important as the Segregation Formula adopted (Vol. I, Ct. Tr., 154-159; fols. 461-477). In the instant case, from the standpoint of the Georgia and

Alabama Railway particularly, the period selected, 1936 to 1940, inclusive, were all unusually poor earning years, with the exception of the year 1936 (Vol. I, Dist. Ct. Op., p. 115).

The expert, Wyer, testified that the earnings for the period 1932 to 1939 were abnormal and probably would be the lowest earnings in the history of the Seaboard (Vol. I, Ct. Tr., 197-198; fol. 592). Furthermore, both experts, Wyer and Kennedy, testified that several of these years which were used as a yardstick, will not be repeated (Vol. I, Ct. Tr., pp. 154-156, 196-199, 229).

The District Court adopted this period of low level earnings proposed by the Special Master in order to establish a conservative capitalization, particularly in so far as *fixed charges* were concerned (Vol. I, Ct. Tr., pp. 197-198; fols. 589-596).

After ascertaining the net income for the average year in the period 1936 to 1940, the Master and District Court used this as a base to ascertain and thereby fix the amount of new First Mortgage Bonds to be issued (Vol. I, Ct. Tr., p. 249).

These First Mortgage Bonds were then distributed to the mortgage divisions which showed earnings during its low level period, in ratios proportionate to their relative earnings. If the mortgage division showed no segregated earnings during this period 1936 to 1940, it received no First Mortgage Bonds (Vol. III, p. 22, Cir. Ct. Op.).

However, the District Court, in distributing junior securities, to wit, Income Bonds, Preferred and Common Stock, used the same level of earnings for such distribution as it did for the distribution of the senior securities or First Mortgage Bonds. In other words, if a mortgage division showed no segregated earnings in the low level period adopted, 1936 to 1940, it not only failed to receive First Mortgage Bonds but also failed to receive any Income Bonds, Preferred Stock or Common Stock, which was dis-

tributed on a segregated earnings basis. This was erroneous. Both experts, Kennedy and Wyer, opposed this treatment (Vol. I, Ct. Tr., pp. 209-213, 201, 244-246).

The evidence introduced supported the allocation of First Mortgage Bonds on a segregated earnings basis established in the period 1936 to 1940 since it was sufficient only to meet the fixed charges required for the payment of interest on all the First Mortgage Bonds. But there was no evidence to support the use of this period for the allocation of junior securities (Vol. I, Ct. Tr., pp. 198-201, 209, 213, 276-279). The Special Master and District Court used the same earnings basis in distributing junior as well as senior securities, instead of first ascertaining the level of earnings commensurate with that required to meet the charges upon each grade of junior securities before making its distribution of the different grades of securities (Vol. I, Ct. Tr., pp. 198-201, 209-213).

In other words, the District Court fixed certain low annual charges (indicated by the Kennedy synthetic average year net revenue) which it said the System earnings would certainly cover, no matter what happened, and this was payable as interest on all the First Mortgage Bonds. The court then, in effect, said, if there were more earnings, they will be paid out on the Income Bonds, but only if the funds were earned. This was likewise true of the Preferred Stock and Common Stock.

The principle, however, is entirely different from that applied by the District Court in its distribution of First Mortgage Bonds. One is based on fixed charges, and the other is based on income which is paid only if earned. In order to earn money which can be used to pay the interest and dividends on the junior securities, it is apparent that the System must earn *above* the level fixed in the period of 1936 to 1940, since these earnings are devoted entirely to the payment of interest on the first mortgage bonds (Vol. I, Ct. Tr., pp. 198-201, 209-213).

In order to do so, the System and necessarily the various mortgage divisions must actually earn much more than originally contemplated in the *synthetic* average year. If the System and the mortgage divisions do earn more money which can be applied to the payment of interest on the income bonds and possibly dividends on the stock, what actually happens is that the earnings ratio of each mortgage division changes, and the earnings of the G. & A. Ry., as well as all the other so-called "deficit lines", would have to be much greater, in which event, it follows that they are entitled to a more equitable distribution.*

This fact is most forcibly and clearly demonstrated by Wyer's Court Exhs. 1 and 2 (Vol. I, 409-410). These exhibits (on the same basis used by Kennedy to compute the earnings of the other years in 1936 to 1940), applied the "Kennedy Formula" to the System's earnings for the year 1942 in order to ascertain the earnings of the G. & A. Ry. and South Bound Divisions in the year 1942. Wyer's Ex. 1 showed that under the "Kennedy Formula" and after all adjustments required therein, the G. & A. Ry. in 1942 had a gross income in the sum of $1,016,937—or an actual increase in earnings in 1942 of $1,230,242 as compared with the 1939 results under the "Kennedy Formula". At the same time, the exhibit showed that the operating ratio of costs as compared with the railroad operating revenues for 1942 was 65.4% as compared to 86.6% for the year 1939. This phenomena applies to all operating railroads; if the volume of business increases substantially, not only does the gross revenue increase proportionately, but the ratio or percentage of operating costs decreases as well. The effect is twofold (1) an increase in the gross revenue, and (2) a decrease in the normal operating expense. Kennedy and Wyer both testified that the level of earnings used for the distribution of junior securities should always

*See Swaine Article (*supra*) Harvard L. Rev. (July, 1943), pages 1215-1217.

be, equitably, at a much *higher level* than that used for the distribution of senior securities, since no interest or dividends could be received on these junior securities unless the level of earnings was much higher and produced the income necessary for that purpose (Vol. I, Ct. Tr., pp. 209-213; 244-246).

In discussing the same problem in the *Milwaukee* case, *supra*, Mr. Justice Douglas, 318 U. S. 561, 563, said:

> " * * * But where as here each group of bondholders is contributing to a new system mortgage separate properties from old divisional mortgages, it is necessary to fit each into the hierarchy of the new capital structure in such a way that each will retain in relation to the other the same position it formerly had in respect of assets and of *earnings at various levels.* * * * No fixed rule supplies the method of bringing two divisional mortgages into a new capital structure so that each will retain in relation to the other the same position it formerly had in respect of assets and of *earnings at various levels.*" (Italics supplied.)

It is clear from the Special Master's Report (Vol. II, pp. 256-258) that the District Court distributed 50% of the income bonds and 33 1/3% of all of the preferred and common stock solely upon the basis of the segregated earnings of each division, in the period 1936 to 1940, under the formula adopted. It is also clear that if the segregated earnings period adopted for the partial distribution of junior securities was based on earnings for the year 1942, instead of earnings based on the period 1936 to 1940, and the gross income of the G. & A. in 1942 was 3% of the System gross income, the G. & A. division would have received 3% of all the junior securities allocated on the basis of segregated earnings. It is estimated that

this would amount to approximately an additional $780,000 in income bonds, $150,000 preferred stock and $850,000 in common stock for the G. & A. division.

It is likewise clear that the only distribution of junior securities made to the socalled "deficit divisions" were based solely upon their traffic contributions (in a low average year) and their physical value. The socalled "deficit divisions" (which included the G. & A. division) as they had no segregated earnings in the period employed, did not share in the junior securities which were distributed upon the segregated earnings basis. The probability that they would have earnings in better years was not reflected nor was there reflected the fact that in order to meet the interest and dividend payments required under junior securities the level of earnings for the socalled deficit lines would have to be much greater than that which existed in 1936 to 1940, in which event it follows they would no longer be deficit lines and hence entitled to a much more equitable distribution.

It will be seen that the erroneous principle applied by the District Court and Circuit Court of Appeals (Vol. III, pp. 33-34) for the distribution of junior securities has greatly prejudiced the G. & A. bondholders and that they would have received substantial amounts of additional junior securities had the proper level of segregation earnings been applied.

In any event the method or principle applied for the distribution of junior securities by the courts below is in conflict with the applicable decisions of this Court and for that reason should be reviewed and reversed. (*Group of Institutional Investors* v. *Chicago, Milwaukee, St. Paul & Pac. R. R. Co., supra.*)

POINT V.

The Circuit Court of Appeals erred in approving the allocation made to the Georgia and Alabama bondholders under the Plan of Reorganization where the District Court and Special Master failed to consider or apply the segregation formula adopted to the recent earnings in the years 1941 to 1943. The resulting allocations were obsolete and violated Section 77, subdivision (e) of the Bankruptcy Act.

Section 77 subdivision (e) of the Bankruptcy Act provides:

> "The value of any property used in railroad operation shall be determined on a basis which shall give due consideration to the earning power of the property, *past, present,* and *prospective* and all other relevant facts." (Italics supplied.)

The Primary Allocation made under the "Kennedy Segregation Formula" adopted by the Master is based on the earnings of the synthetic average of several years, 1936 to 1940, inclusive (Vol. I, Ct. Tr., 271-272). The earnings for these years were very low and several of these years used for the segregation yardstick by the Master both experts Wyer and Kennedy testified will not be repeated (Vol. I, Ct. Tr., 154-156, 196-199, 229, 387). In addition, Kennedy and Wyer testified that it was impossible to estimate what the future income or revenues of the Seaboard System will be, that the situation of the Seaboard Railway is always very changeable and that there are many variable factors which may and will affect its future income (Vol. I, Ct. Tr., 229, 387).

The Primary Allocation proposed by the Master and adopted by the Courts below is obsolete as the Master made no attempt to apply the segregation formula to the

years 1941, 1942 and 1943, and in reality he had no segregation studies of earnings for these years (1941, 1942, and 1943) to indicate the many changes in earnings position which factually had taken place among the various divisions; nor did the Master (because he had no studies for the years 1941 to 1943) compensate these divisions for their earnings for these years and for their contribution to the present cash position of the System (Vol. I, Ct. Tr., 222-224, 198-201, 276-277).

While it may be proper to use a period of low level earnings in order to establish a conservative and permissible capitalization which will prevent the return or necessity for any future reorganization, it is not necessary or fair to use this low lovel of earnings as a basis for determining the relative earning power of each of the various mortgage divisions of the System* (Vol. I, Ct. Tr., 197-201).

The principles set forth by Congress under Section 77 for establishing value in a railroad reorganization in bankruptcy are equally applicable to a reorganization in equity. It is clearly stated in Section 77 that to determine the value of any property, the earning power, *past, present and prospective,* must be considered.

The Master and Courts below omitted entirely and gave no consideration whatever to the immediate past and present earnings of the System (Vol. I, Ct. Tr., 222-224, 197-198).

Wyer's Court Exhibits No. 1 and No. 2 (Vol. I, pp. 409, 410) and his testimony (Vol. I, Ct. Tr., 157-162) which were not refuted, clearly proved that even assuming, *arguendo,* that the application of the Kennedy Formula adopted by the Master was correct in the first instance, that if the same formula was projected to the earnings for the year 1942, the net income for the G. & A. divi-

*See Swaine Article, Decade of Railroad Reorganization, under Section 77, *supra,* Harvard Law Review (July 1943).

sion was $1,016,937. Furthermore, on the same basis, the estimated earnings of the G. & A. Ry. for 1943 were $1,500,000 to $2,000,000.

These figures did not take into account, moreover, the adjustment in earnings which Wyer said should have been made in favor of the G. & A. Ry. in the sum of approximately $100,000 for (1) abandonment of the Albany Line; and (2) the passenger deficit charge which was improperly charged against the G. & A. Ry. (Vol. I, Ct. Tr., 218-222).

Furthermore, Wyer testified on cross-examination that as the earnings of the Georgia and Alabama Railway increased in the years 1942 and 1943, the contribution by the Georgia and Alabama Railway to the gross average revenue of the System likewise necessarily increased (Vol. I, Ct. Tr., 374-375). Considering that the Georgia and Alabama Railway contribution to the freight revenue of the System amounted to a net of $922,567 in 1939 when the Georgia and Alabama Railway purportedly had a deficit of $222,017 under the "Kennedy Segregation Formula", it must be recognized that the contribution by the Georgia and Alabama Railway to the freight revenues of the System in the years 1942 and 1943, when it admittedly had enormous earnings approximating $1,000,000 to $2,000,000, must have been considerably larger than the sum of $922,567 indicated for the year 1939. It will undoubtedly be argued that the earnings for the years 1941 to 1943 represent wartime earnings and should not be relied upon. In answer thereto, it must be noted that there is a great distinction between using wartime earnings as a base for establishing future earnings and the consideration of wartime earnings as actually earned; one is based *in futuro*, the other is an accomplished fact.

The District Court recognized and acknowledged this distinction (Vol. I, Ct. Tr. 325-327, 346-347).

Thus the fact that the Georgia and Alabama Railway earned, even on the basis of the "Kennedy Segregation

Formula", $1,016,937 in 1942 and approximately $1,500,000 to $2,000,000 in 1943, and in addition contributed enormously to the gross average revenue of the System in these years, was not considered or reflected in any manner by the Master in his allocation of securities or formula which unquestionably affected the final allocation to the Georgia and Alabama Railway Division very substantially.

Hence it is contended that the Plan of Reorganization approved by the Courts below, which adopted the Allocations and Segregation Formula proposed by the Master is erroneous and inequitable to the Georgia and Alabama bondholders.

POINT VI.

The approved Plan of Reorganization is erroneous in that it fails to compensate the bondholders of the Georgia and Alabama Railway for the full amount of their claim and in that it allocates to said bondholders greatly inferior and junior securities in exchange for their first mortgage bonds.

The Plan of Reorganization allocates to each G. & A. bondholder First Mortgage Bonds in the sum of $58.74; Income Bonds in the sum of $262.55; Preferred Stock in the sum of $107.88 and Common Stock in the sum of $614.61; making a total in the sum of $1,043.78. The total claim, including interest to January 1, 1944 per $1,000 bond of principal of each G. & A. bond is $1,625.

It is seen from the foregoing that the only senior security offered to the G. & A. bondholders are First Mortgage Bonds in the sum of $58.74 for each $1,000 bond. Assuming that the Income Mortgage Bond is a senior security, which it admittedly is not, the total amount of the First Mortgage and Income Bonds is $321.29. The balance of the securities offered are stocks which are greatly inferior and junior securities.

The Plan makes no attempt to compensate the G. & A. bondholders for their loss of their first mortgage position which is unquestionably of great value to them. In addition, the securities allocated to the bondholders are *much less* than the face amount of their claims and composed mostly of stock subject to a vast amount of prior liens. This was due to the principles of allocation adopted which determined the quantitative participation of the several mortgage divisions in the several classes of new securities which had to be allocated.

In allocating the new securities to the several divisions, the Master and Courts below proceeded on the following principle: In the Primary Allocation, all of the First Mortgage Bonds, one-half of all the Income Bonds and one-third of all the Preferred and Common Stock, were allocated on the basis of the average segregated earnings in the five-year period 1936 to 1940. 50% of the Income Bonds and 33-1/3% of the Preferred and Common Stock were allocated on the basis of the net value of freight contributions made by the several divisions to the System—33-1/3% of all the Preferred and Common Stock were allocated on the basis of reconstruction cost—new, less depreciation of the several mortgage divisions. In the Secondary Allocation, *all* of the securities were allocated on a basis of segregated earnings indicated for each mortgage division in the period 1936 to 1940.

It must be noted that all of the divisions, even those showing segregated earnings, participate in the distribution of Income Bonds and Stock distributed on the basis of net value of freight contributions. It must likewise be noted that all of the divisions, including those which showed segregated earnings, participated in the distribution of Preferred and Common Stock distributed on the basis of reconstruction costs new, less depreciation.

Let us analyze the effect of this principle of allocating all of the First Mortgage Bonds, 50% of the Income Bonds

and one-third of the Preferred and Common Stock *only* to the mortgage divisions which showed segregated earnings.

All of the First Mortgage Bonds were distributed only to those mortgage divisions which show segregated earnings. Then 50% of all the Income Bonds distributed were likewise distributed to the very same "earning divisions". Then one-third of all the Preferred and Common Stock were also distributed to the same "earning divisions". In effect, payment upon payment upon payment were made to the very same "earning divisions" without receiving in turn any credit for a previous payment. In addition, these very same divisions participated in the distribution of Income Bonds which were distributed on the basis of net value of freight contribution and also participated in the distribution of one-third of the Preferred and Common Stock which were allocated on the basis of reconstruction costs new, less depreciation. These pyramided payments were taken from the bondholders represented by the petitioning-appellants and other mortgage divisions who were entitled to share in them.

Obviously certain divisions received *over-favorable* treatment under the Master's Plan. This was objected to by the District Court as constituting a "bonus". Thus the Carolina Central Railroad Company Division, whose principal and interest aggregated as of January 4, 1944, $4,017,620, received a total par value of new securities in the sum of $10,285,526 consisting of the following: First Mortgage Bonds, $1,595,562; Income Mortgage Bonds $3,207,438; Preferred Stock $1,064,188; and Common Stock $4,418,340, more than six million dollars in excess of their total claim. The District Court in its opinion stated that this defect was remedied by the Compromise Committee by the process of "commutation" which substituted for the larger face amount of junior securities, *senior* securities of an equivalent value but smaller

face amount so that no mortgage division received more than the principal and interest of its whole claim in new securities at par.

However, the process of "commutation" does not cure the defect, it merely *conceals* the defect. The mortgage division which received the surplus of new securities did not surrender them but exchanged them for superior senior securities in a smaller face amount. Hence it obtained senior securities far in excess of the relative amount it should have received in the first instance. The excess so received must necessarily have been taken from the other mortgage divisions who are entitled to share them.

Thus "segregated earnings" under the processes and principles adopted by the Courts below were given so much weight that the resulting distribution was entirely out of proportion to the actual value of these Mortgage Divisions and their *relative value* in respect to the entire System.

The chart annexed to the District Court's Opinion showing the final allocation of new securities as of January 1, 1944, indicated that the G. & A. Ry. received the poorest treatment per bond of all of the underlying mortgages (Vol. I, p. 426). Even the South Bend which is practically a passenger line entirely, and of far *less value* to the *System* than the G. & A. Ry., receives securities in the face amount of $1,302.17, per bond, as compared with the $1,043.78 for the G. & A. bondholders. All of the other underlying divisional liens receive securities practically of the same par value as the total amount of their claim in addition to *superior* securities.

It is submitted that just as it was improper for the Master to give to the Carolina Central and the Florida Central and Peninsular par value securities far exceeding the total amount of their claim, so is it similarly erroneous to give the G. & A. bondholders par value securities far less than the face amount of their claim which, in ad-

dition, are mainly composed of junior securities or stock.

"The rule of absolute priority" is irrebuttably established in two recent Supreme Court cases:

> *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106 (1939); and
> *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510 (1941).

In the *Consolidated Rock Products case*, 312 U. S. 510, 528 *et seq.*, the Court said that bondholders must be *"made whole"*. Their loss of their former senior fixed charge position through allotment of *"an inferior grade of securities"* necessitates that *"full compensatory* provision * * * be made for the entire bundle of rights which the creditors surrender". For surrendering senior rights, creditors must receive *"full compensatory treatment"*. They are entitled to have the *"full value of the property*, whether *present* or *prospective*, for dividends or only for purposes of control first appropriated to payment of their claims." (Italics supplied.)

That the treatment is unfair and inequitable is further illustrated by the net salvage value of the G. & A. Ry. One cannot compare the value of a railroad as junk or scrap value with the same railroad as a going operating business. Yet the Receivers of the Seaboard, as shown by their Special Master's Exh. 517 (Vol. I, 607) fixed the net salvage value of the G. & A. Ry. at $1,200,000 *exclusive* of rights of way whereas the total *value* of all the securities received by the G. & A. Ry. is estimated to amount to $1,792,106.

It is apparent from the foregoing that the allocation given to the G. & A. Ry. bondholders under the Plan of Reorganization is clearly erroneous, in violation of the laws of the land and should not be sustained in any Court of Equity.

POINT VII.

The Segregation Formula adopted for the purpose of determining the earnings of each Mortgage Division and the resulting allocation of new securities is predicated upon false and artificial assumptions and hence is erroneous and inequitable.

The basic distribution of new securities in the approved Plan of Reorganization between the several classes of mortgagees, having claims of equal rank against different assets of the Seaboard System, is predicated upon three allocations, known as Primary, Secondary and Tertiary Allocations.

The Segregation Formula adopted by the Courts below, to determine the earnings of each of the mortgage divisions, is of *primary* importance since the segregated earnings of each mortgage division, in effect, establishes the *relative value* of that division to the System. The Secondary Allocation is predicated *entirely* upon the segregated earnings of each division under the Formula adopted; and the Primary Allocation was derived principally from the Segregation Formula since all of the First Mortgage Bonds, one-half of all the Income Bonds and one-third of all the Preferred and Common Stock is distributable solely on the segregated earnings indicated in the period 1936 to 1940 (Vol. III, pp. 27-29, Cir. Ct. Op.).

The Segregation Formula adopted by the Courts below was the *yardstick* employed to determine the expenses and revenues attributable to each of the Railroad Mortgage Divisions in order to ascertain the net earnings of each of the mortgage properties. Many of the mortgage divisions of the System under the "Kennedy Segregation Formula" showed *no* net segregated earnings and were designated as "deficit lines" (Vol. I, Dist. Ct. Op., 108).

Distribution Under "Segregation Formula" to G. & A. Ry.

The adopted "Kennedy Formula" stated that the G. & A. Ry. income in the average year for the period 1936 to 1940 is a deficit in the sum of $222,017 after all adjustments (Vol. II, Table 2, S. M. Rep.).

Under the "Kennedy Segregation Formula", the G. & A. Ry. received no First Mortgage Bonds as it had no segregated earnings. In view of the net value of its freight contributions, it received Income Mortgage Bonds in the sum of $1,599,640; Preferred Stock in the sum of $373,903 and Common Stock in the sum of $2,129,517. The estimated cost of the reproduction new, less depreciation as of December 31, 1941 is $7,886,829. Based on this valuation, the G. & A. Ry. was allotted Pfd. Stock in the sum of $285,894 and Com. Stock in the sum of $1,619,231.

The Master's *total* Primary Allocation to the G. & A. Ry. was $1,599,640 in Income Bonds, $659,797 Pfd. Stock and $3,748,748 Com. Stock. The G. & A. Ry. received no securities under the Secondary Allocation as it showed no segregated earnings.

Definition and Purpose of a Segregation Formula.

There are many segregation formulas (Vol. II, S. M. Rep. 214-226). A segregation formula attempts to allocate to the various divisions of the system the earnings and expenses reasonably attributable to each mortgage division or segment of the system. A segregation formula purports to ascertain, by these means, the net earnings of each segment in order to establish the relative value of each mortgage division to the railroad system (Vol. II, S. M. Rep. 214-226).

However, the term "segregation" as employed is not used in its usual legal sense to wit: that the item segregated is distinctly identifiable or distinguishable on its face. As employed herein, "segregation" is in reality

synonymous with the term "allocation" (Vol. I, S. M. Tr., 471-472, 475-476). In order to segregate the revenue and expenses attributed to the various divisions, certain arbitrary and artificial assumptions must be adopted (Vol. I, S. M. Tr., 437-446). The purported segregation earnings, therefore, derived from the use of the formula are dependent upon these assumptions and have no greater validity than the artificial and arbitrary basis upon which they are predicated (Vol. I, S. M. Tr., 437-446).

Problem.

The real problem is how to fairly determine what should be the proportionate shares of each of the several divisions, all of which are first liens of equal rank, in the several classes of new securities to be issued.

In principle, the various creditors of the insolvent Corporation should receive in the new securities to be issued of the proposed Corporation, the *equitable positional equivalent* each formerly possessed.

In discussing the same problem in the "Milwaukee" case (*Group of Institutional Investors* v. *Chicago, Milwaukee, St. Paul & Pac. R. R. Co.*), 318 U. S. 561, 563, Mr. Justice Douglas said:

> "* * * But where, as here, each group of bondholders is contributing to a new system mortgage separate properties from old divisional mortgages, it is necessary to fit each into the hierarchy of the new capital structure in such a way that each will retain in respect to the other the same position it formerly had in respect of assets and of earnings at various levels. If that is done, each has obtained new securities which are the equitable equivalent of its previous rights, and the full priority rule of the *Boyd* case, as applied to the rights of creditors *inter se*, is satisfied. * * *"

In order to determine the equitable equivalent it is necessary to ascertain the *relative value* of each of the mortgage divisions.

Sub-section (e) of Sec. 77 of the Federal Bankruptcy Act provides:

> "The value of any property used in railroad operation shall be determined on a basis which shall give due consideration to the earning power of the property past, present and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land in the light of its earning power and all other relevant facts."

However, as stated by Mr. Justice Brandeis in the case of *Southwestern Bell Telephone Company* v. *Public Service Commission*, 262 U. S. 276, 310, "Value is a word of many meanings".

Mr. Justice Douglas in the *Milwaukee* case, *supra*, said:

> "It covers its meaning in a particular situation from the purposes of which a valuation is being made. Thus the question in the valuation for rate making is how much a utility will be allowed to earn. The basic question in a valuation for reorganization purposes is how much the enterprise in all probability can earn."

In resolving the problem of *permissible capitalization* of a reorganized company, earning power was the primary test in equity receivership proceedings as well as any former railroad reorganizations.

In the "*Milwaukee* case", *supra*, in discussing the *permissible capitalization*, this Court said:

> "The basic question in a valuation for reorganization purposes is how much the enterprise in all probability can earn. Earning power was the primary test in former railroad reorganizations under equity receivership proceedings. *Temmer* v. *Denver Tramway Co.*, 18 F. 2d 226, 229; *New York Trust Co.* v. *Continental & Commercial Bank*, 26 F. 2d 872, 874. The reasons why it is an appropriate test are apparent. A basic requirement of any reorganization is the determination of a capitalization which makes it possible not only to respect the priorities of the various classes of claimants but also to give the new company a reasonable prospect for survival. * * * Certainly there is no constitutional reason why earning power may not be utilized as a criterion for determining values for reorganization purposes. And it is our view that Congress when it passed Section 77 made earning power the primary criterion."

Although earning power seems to be the only and primary test or basis for *ascertaining permissible capitalization*, it does not necessarily follow that this is true for the ascertainment of the relative values of various separate mortgaged properties of a railroad system. This was likewise observed by Judge Chesnut (Vol. I, Ct. Tr., 260-263, 265, 293-295). Mr. Warner, testifying before the Master, expressed it as follows:

> "A well rounded railroad system is a thing of many parts each of which has its distinctive functions or purposes and the question of the relative value of each to the whole hinges on its contribu-

tion to system results. Merely because some of these are less susceptible to mathematical evaluation does not make them any the less real. Mr. Kennedy expressed it well where at page 1121 of the record, he stated that:

> 'There are all kinds of different elements of value that a mortgage line can have to a system. It may have heavy earnings on the traffic it carries; it may have a high strategic value in its access to important industries or other important sources of traffic; it may contribute a great deal of traffic to the remainder of the system. All those things enter into the determination of the value of a mortgage line and its value relative to the other lines in reorganization'" (Vol. I, S. M. Tr., 464-465).

The Master attempted to ascertain the actual earnings of each of the mortgaged properties during a certain period (1936-1940), through the use of the "Kennedy Segregation Formula" which he adopted. This formula endeavored to *separate* each of the mortgaged properties and treat each division as if it were a separate operating railroad, and then allocated to each division certain expenses and revenues of the System in order to ascertain the net earnings of each division. After thus ascertaining the purported net earnings of the various divisions the Master allocated to the various divisions, based upon their relative percentages of the so-called "segregated earnings", all of the new first mortgage bonds, one-half of the income bonds and one-third of all the preferred and common stock. However, based on the so-called "segregation" formula, certain of the mortgage divisions, including the G. & A. Ry. had *deficits*, instead of net earnings and did not share in the Primary Allocation of the first mortgage bonds, income bonds and stock which

were distributed solely on the basis of segregated earnings (Dist. Ct. Op., p. 108). This was likewise true of the Secondary Allocation.

The fairness of any formula must be judged by the results of its application. This is particularly true in the case of a railroad inasmuch as the facts in respect to any railroad system are so different, varied and complex (Vol. I, Dist Ct. Tr., 200; Vol. I, S. M. Tr., 437-460).

As stated by the District Court in its opinion (Vol. I, 109, 114):

> "There is no uniformly recognized yardstick for the calculation of the net earnings of separate Divisions of a unified railroad system. * * * It must be remembered here that there is no rule of law which prescribed the criteria for the determination of earnings of separate railroad divisions in one system."

In the *"Milwaukee"* case, *supra*, Mr. Justice Douglas said (p. 563):

> "The problem in such a case is not a simple one. The contribution which each division makes to a system is not a mere matter of arithmetical computation. It involves the appraisal of many factors and the exercise of an informed judgment. Furthermore, an attempt to put precise dollar values on separate divisions of one operating unit would be quite illusory. As the Commission recently stated: 'The properties comprise one operating unit; a complete separation of values would necessarily have to be based on extensive assumptions of unprovable validity; and any attempt at such a separation would in the end serve no purpose except to present an apparent certainty in the formu-

lation of the plan which does not exist in fact'."
* * *

Nevertheless, the "Segregation Formula" adopted by the Master and Courts below has in effect, endeavored to do the very thing which this Court and the Interstate Commerce Commission said *could not be done*. Furthermore, the unfairness of the results of the "Kennedy Segregation Formula" is recognized and admitted in fact by the Master at pages 246, 247 of his Report (Voll. II) when he states:

> "It should be remembered that each of the lines upon which the deficit occur upon any of segregation formulae is a part of the integrated system. It is readily conceivable that the method of determining value of the segregation might operate unjustly against portions of the system and reflect a loss, unless regard is had to many other elements of value which are present and make their contribution to the success of the entire operation. The apparent loss might result from circumstances, none of which should necessarily occasion a penalty when the contribution to the joint enterprise is properly evaluated. * * * Strictly speaking, the term deficit line is a misnomer and its treatment as such in the final analysis implies a criticism of the system management, for the obvious step in the case of any portion of the property which *per se* is not paying its way directly or indirectly, is abandonment. It is therefore concluded and it is so found that any line that is comprised within a Plan of Reorganization as herein recommended will be accorded such treatment in the allocation of securities as the elements of value possessed by it may warrant even though under the segregation formula it fails to disclose earnings."

Nevertheless, in his allocation of new securities, the Master allocated *all* the first mortgage bonds, *50%* of the Income Bonds and *one-third* of all the Preferred and Common Stock *solely* on the basis of segregated earnings made by each mortgage division in the period 1936 to 1940, and made no variation therefrom.

In addition, his Secondary allocation which redistributes most of the securities released by the Receivers purchases which amounted to $34,000,000 (see Point 3 of Brief) is also predicated *solely* upon segregated earnings and distributed only to those mortgage divisions which showed segregated earnings in 1936 to 1940.

How Does One Ascertain the True Earning Power of Separate Mortgage Properties Which Comprise One System Operated as a Unit?

In considering the relative value of each divisional property, the yardstick which seems to have been adopted by the Master and the Courts below is the *earning power* of the mortgaged property. In trying to measure the earning power of each of the various divisions, they adopted a yardstick known as the "Kennedy Segregation Formula", which purported to treat each divisional mortgaged property as a separate operating railroad, allocating through the use of the particular formula, the various expenses and revenues of the System to each of these divisions and thereby ascertaining the purported net earnings of each division in the years selected.

It is clear that if one is seeking to measure the earning power of a segment or division of a railroad system, the important element is not what each individual division earns, as if it were presumably operating by itself, but what the *System actually earns* through the operation of each mortgage division as part of the System; that, in reality, represents the earning power of that particular

mortgage division. As Col. Anderson, one of the Receivers expresses it:

> "If a railroad is to be dealt with as a whole and each mortgage division within that system is to be given equitable treatment in reorganization, it is manifest that the problem involved is not the ascertainment of the earning power and value of each mortgage division as a separate railroad but is the ascertainment of the relative earning power and value of each mortgage division in its relation to all other mortgage divisions in a system operated as a unit" (Vol. I, S. M. Tr., 446).

Basic Fallacy of the Adopted Segregation Formula.

The "Kennedy Segregation Formula" is based upon the false and artificial assumption that each mortgage division is operating as a separate railroad. That is contrary to the facts. The System before the receivership and during the receivership has been operated as a whole. Each mortgage division is dependent upon other mortgage divisions for the origination, handling and termination of freight moving over more than one mortgage division. The revenues of all divisions are taken into a common treasury and the expenses of operating all divisions, whether assigned segregated revenues are adequate or not, are paid out of the common treasury (Vol. I, S. M. Tr., pp. 438-440, 462-463).

In addition, the segregation formula artificially and arbitrarily assumed numerous special allowances or arbitraries to compensate in whole or in part for the assumed cost of origination and termination of business, terminal expenses etc. These assumptions are entirely unrealistic and mostly *guess work*. Under the segregation formulas, if a deficit line could not meet its expenses, the System

nevertheless, paid it, whereas in truth and in fact, if a mortgage division was unprofitable and a loss to the System, that mortgage division or line would be *abandoned* (Vol. I, S. M. Tr., pp. 462-463; Vol. II, S. M. Rep. 246-247). The effort of the "Kennedy Segregation Formula" to treat each mortgage division as a separate operating railroad therefore, in the distribution of earnings and expenses is based upon assumptions which are contrary to the facts of the situation and wholly unrealistic (Vol. I, S. M. Tr., pp. 438-440, 462-463; Vol. I, Ct. Tr., pp. 234-243).

While theoretically the mortgagee is entitled to a foreclosure of the mortgage and to enforce the rights thereunder, this is not the case under the present law. The Courts have held that the *public* interest in railroads is dominant. To the extent required by public interest, a railroad must be operated as a unit and sold as a unit when foreclosed. No railroad or a part of the railroad can under existing law be sold or transferred to a purchaser except with the approval of the I. C. C. Obviously, the Commission could not find that the sale of mortgage divisions separately, is in the public interest. Therefore, the several mortgage divisions cannot be segregated from the System, but must be reorganized as a whole. This conclusion is necessary both under the Interstate Commerce Act and Section 77 of the Bankruptcy Act which in effect, suspends the right of foreclosure and provides for the reorganization of the system as a system (Vol. I, S. M. Tr., pp. 440-441)

Viewed properly, the real inquiry in any reorganization of a railroad system under the existing law is as to the *relative value* of each of the several mortgage divisions *as a part of the System*, not individually as a separate operating railroad. The relative extent to which the System does benefit or earn income by the use and operation of each of the mortgage divisions in effect,

establishes the relative value of the several mortgage divisions in relation to each other.

The complete unfairness of the "Kennedy Formula" and its results is illustrated forcibly by S. M. Exh. 415 (Vol. I, 591) introduced by the expert, Wyer, which shows the contributions in 1939 of each of the mortgage lines to the System's gross income from freight traffic under the "Wyer Formula". (The results under the "Wyer Formula" for the G. & A. Ry. are poorer than under the "Kennedy Formula".) 1939 was one of the poorest years from the standpoint of the G. & A. Ry., yet this Exhibit 415 shows that the G. & A. division contributed to the balance of the System the sum of $1,248,660 in freight revenues and that the balance of the System contributed to the G. & A. line in turn the sum of $326,099, leaving a net contribution by the G. & A. division to the System in the sum of $922,567, or 13.10% of the *total* annual net income derived by the System from freight traffic. As the history of Seaboard has shown, it is an acknowledged fact that the only profitable revenue obtained in the System is that obtained through freight traffic and not passenger traffic which has always been conducted at a great loss (except in the recent war years) (Vol. I, Ct. Tr., pp. 219-222).

Yet under the adopted Master's "Segregation Formula", the G. & A. Ry. is designated as a deficit line with no earnings, but a purported deficit in the sum of $220,107. The unfairness of the Master's "Segregation Formula" was further emphasized by Wyer's testimony (Vol. I, Ct. Tr., 157-164) and Wyer's Ct. Exh. No. 1 (Vol. I, 409) which clearly proved, even assuming the Master's Formula to be correct in the first instance, that if the Segregation Formula were projected to the year 1942, the net railway operating income for the G. & A. Ry. in 1942 was $1,016,137, and that on the same basis the estimated earnings of the

G. & A. Ry. for the year 1943 were $1,500,000 to $2,000,000. Furthermore, these figures are based upon the "Kennedy Segregation Formula" which do not properly reflect in the first instance the true earnings or value of the G. & A. Ry. In addition, the above figures do not take into account the adjustments which Wyer testified should have been made for the G. & A. Ry. in the approximate amount of $100,000 for (1) the abandonment of the Albany Branch and (2) the unfair passenger deficit charged against the G. & A. Ry. (Vol. Ct. Tr., pp. 218-222).

The unfairness of the Master's Plan in predicating his allocations primarily on the Kennedy Segregation Formula, which resulted in setting a valuation of $1,433,463 for the G. & A. Ry. is also strongly indicated by the fact that the estimated *salvage value* of this line approximates this sum, since the Receivers in their statement dated March 5, 1942 (S. M. Exh. 517; Vol. I, 607), found the estimated gross salvage value of the G. & A. Ry. to be approximately $1,200,000 *exclusive* of all rights of way.

The basic fallacy of the "Kennedy Formula" and the other proposed segregation formulas was recognized by both of the Receivers of the System. This fallacy consisted of the fact, that in reality, there *was no deficit* mortgage division; that the so-called earning lines were entirely dependent upon the so-called deficit lines for their purported earnings and that their earnings under the segregation formula were due in great part to the contributions of the so-called deficit lines (Vol. I, S. M. Tr., pp. 462-463, 438-460; Ct. Tr., pp. 234-243). The Receivers testified both before the Master and the District Court at their request. The Receivers endeavored at all times to be impartial and had no personal interest in the segregation formula adopted.

Col. Anderson, one of the Receivers, pointed out the basic *fallacy* of the segregation formula adopted, was that

it was predicated on an assumption entirely contrary to the facts, to wit, that each of the mortgage railroad divisions was a separate operating railroad (Vol. I, S. M. Tr., pp. 438-441). He indicated that the effect of the application of the segregation formula was to reward or enrich the so-called central or bridge lines which were usually low level lines which originated and terminated very little traffic (Vol. I, Ct. Tr., pp. 239-242; S. M. Tr., pp. 438-441). That the divisions or lines which tapped the sources of the business carried by the System and from which most of the freight originated or terminated, were generally steep grade divisions whose terminal costs were very high in comparison with the other division lines and whose operating costs also were much higher than the central or bridge lines. As he expressed it, if there were three mortgage divisions, and two of the divisions passed through mountainous territory but originated and terminated practically all of freight carried on the railroad system, and these two divisions were connected by the third division which was a low-level and low operating cost line, the application of the Kennedy, Wyer or General Formulas would result in the two mountainous divisions, being designated as *deficit lines* and the central or bridge line would be ascribed as the only earning division of the three. Although in reality the central or bridge line in itself was worthless without the other two steep grade originating and terminating divisions, which procured practically all of the business of the System. The System was operated on a profitable basis as a whole, but if one applied any segregation formula as proposed in the instant case, only one division would show any earnings, to wit, the central low-level division and the other divisions which were equally important and indispensable would be designated as deficit divisions and receive no portion of the new securities allocated solely on the basis of segregated earnings.

In contradistinction the Receivers recognized that the important element was not what each division earned separately, as if it were operated separately, but what the *System* or unit as a whole *earned* through the use and operation of each of the various mortgage line divisions and they sought to find the relative values of the several mortgage divisions by estimating the relative contribution of each of the divisions in the final or net earnings of the railway *System* as a whole. They realized that it was ridiculous to say that a division was a non-earning or deficit division, when it was only through the use or operation of that division that a substantial portion of the System's revenues were derived (Vol. I, S. M. Tr., pp. 462-463; Ct. Tr., pp. 239-242). They recognized the inequity of allocating the major portion of securities to be issued, solely upon the basis of so-called segregated earnings but nevertheless continue to operate and use this so-called deficit mortgage division without rendering in turn any compensation whatever for this use to the mortgagees or owners thereof (Vol. I, S. M. Tr., p. 443).

It appears the basic fallacy of the "Kennedy Segregation Formula" is its reliance solely on the assumed earnings of each mortgage division as if each were operated as a separate railroad without considering in any wise the respective contribution made by each division to the System's earnings as a whole (Wyer, S. M. Exh. 415; Vol. I, 591).

To illustrate this clearly, let us assume that a large railroad had the following two mortgage divisions. One division, on the basis of the "Kennedy Segregation Formula", was a good earning line earning for its own division $300,000 a year, but contributing practically no traffic or earnings to the balance of the System as a whole, outside of its individual earnings of $300,000 a year. Let us assume on the other hand, that in the other division we have a so-called "deficit" line which has a deficit of

$200,000 a year as measured by the segregation formula, but nevertheless, this second mortgage division contributed to the net earnings of the entire System $1,000,000 per year; its net contribution to the System, after deducting its deficit of $200,000 per year is $800,000 (this is actually the case with respect to the G. & A. Ry; see S. M. Exh. 415; Vol. I, 591). Let us assume a choice has to be made by the System as to which division it may keep; the System has to decide to abandon one of the mortgage divisions, it cannot keep both.

It is submitted that there cannot be any question, as a matter of pure business judgment, that if there is a so-called deficit division that earns *for the System* a net of $800,000 per year, and on the other hand, this other division which nets on the basis of its own earnings $300,000 per year, but contributes nothing else to the income of the System, the choice would be very plain. The System would still take the so-called deficit line because the System will earn a net of $800,000 on that line per year (Vol. I, Ct. Tr., pp. 309-313, 368-375). The relative value of the so-called "deficit" division *to the System* would be much greater than the so-called "earning" division.

It is clear, if one seeks to ascertain the actual earnings or relative value of each mortgage division as part of a System, that the approach or point of view of the "Kennedy Segregation Formula" is basically wrong. To ascertain the earnings or respective contribution of each of the several mortgage divisions, the only correct method is to ascertain what portion of the earnings of the *System as a whole* were contributed by each of the mortgage divisions. It necessarily follows that the true earning power and relative value of each mortgage division to the System as a whole can be found by not only ascertaining its individual earnings, but by also ascertaining its respective contribution to the System income

as a whole. The sum total of these two figures will actually represent the *total contribution* of each mortgage division to the net income or earnings of the System as a whole and likewise represent its relative value.

CONCLUSION.

It is therefore respectfully submitted that this case is one calling for the exercise by this court of its supervisory powers, by granting a writ of certiorari and thereafter reviewing and reversing said decision.

Respectfully submitted,

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